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SIPDIS
DEPT FOR AF/S, AF/EPS, EB/IFD, AND EB/CBA
DEPT PLS PASS AID FOR /AFR/SA AND EGAD
TREASURY FOR OASIA - E BARBER, USED/IMF, AND USED/IBRD
USDOC FOR 3131/ITA/ANESA/KBRENNAN/JMATHESON
USDOC FOR 4510/ITA/MAC/OA/JDIEMOND
PASS USAID FOR AA/AFR AND AFR/SA
SENSITIVE
E.O. 12958: N/A
TAGS: ECON EAID MZ IMF
SUBJECT: IMF AND MOZAMBIQUE AGREE ON 2005 PROGRAM UNDER PRGF

(U) Sensitive but unclassified - not for Internet Posting - protect accordingly.

¶1. (SBU) Summary: An IMF Mission visited Mozambique from 8-24 September 2004 to review progress under the PRGF and to advise the GRM regarding the 2005 budget. Agreement was reached ad referendum on a Letter of Intent (LOI) for 2005. However, the GRM then changed the 2005 budget methodology, including so-called own revenues (e.g. hospital fees) in the budget, necessitating a rework of the 2005 program. Subsequent to this change, the GRM concluded the concessioning of the Moatize coal fields, necessitating a further revision. The GRM and the IMF now appear ready to finalize the LOI, and the GRM is ready to submit the budget to Parliament. The IMF came away generally quite satisfied with macro developments and structural conditions but noted some slippage in completing structural benchmark actions. GDP growth will be 7.8 percent in 2004, and 7 to 7.5 percent in 2005. Inflation is being brought down to 11 percent in 2004, and in 2005 will be further reduced to 8.5 percent. Exports are up and forex reserves cover nearly six months of imports. Interest rates have declined. The private sector enabling environment, the legal and judicial sector, and HIV/AIDS are the areas of most concern for the Fund. The IMF commended GRM management of the economy in the run-up to the 1-2 December national elections. The Fund encouraged donors to give more in order that the Millennium Development Goals might be achieved. A study of land as collateral for bank loans, the creation of a Central Revenue Authority, VAT refund delays, SISTAFE launch problems, and better harmonization between the IMF and the Budget Support donors rounded out the discussion. End summary.

¶2. (SBU) Background: This message concerns the IMF's first review of progress under the Poverty Reduction and Growth Facility (PRGF) for Mozambique which was approved on 9 July 2004. A Fund Mission visited Maputo from 8-24 September 2004, and returned to Washington thinking that it had essentially completed the review ad referendum. However the draft 2005 budget which was the basis of the 2005 macroeconomic program was subsequently revised quite substantially to include considerable amounts of revenue and expenditure which had been "off budget," often referred to as "own receipts." While this broadening of the coverage of the budget was welcomed, it meant that the macroeconomic program had to be reworked. Then the GRM concessioned the Moatize coal field to the Brazilian conglomerate CVRD for USD 123 million which led to a further reworking of the program. In early December, the GRM was pushing to get Fund agreement so that the 2005 budget and the annual economic and social plan could be finalized and sent to parliament. The IMF would then finalize the PRGF consultation paper with a 2004 date on it, but the Board review target date of 19 January 2005 is likely to slip to February. While some of the 2005 and out year numbers will be changed, we understand that 2004 performance continues on track, and the overall concept of the 2005 program is essentially the same as described in the debriefing reported below. The PRGF is a small program (USD 16.6 million over three years) designed to support the authorities' reform program along with minimal balance-of-payments support. The Fund Mission, headed by Mr. Juan Carlos Di Tata, was timed to provide counsel to the GRM as their 2005 budget was being shaped. The IMF visit coincided with the Mid Year Review (MYR) of progress in economic and social development activities of the GRM. The MYR is conducted jointly by the 15 Program Assistance Partners (a.k.a. the G-15) and the GRM. The Fund team met with the donors several times during the mission in an effort to coordinate with the MYR.

¶3. (SBU) Macro performance 2004 is on track with the program. Real Gross Domestic Product is on a path to 7.8 percent growth in 2004. Prices, as measured by the Maputo index, have risen 12 percent from a year ago, and the 11 percent target for 2004 is still expected to be obtained. There is a shortfall in customs revenue which has been compensated for by expenditure cuts. Monetary growth has exceeded its target due to an accumulation of reserves, and a broadening of application of bank reserve requirements in June has served to slow somewhat the growth of M2 money supply. Exports are up strongly as Mozal's stage II aluminum refinery is now on stream, and natural gas exports to South Africa via the SASOL pipeline have begun. Interest rates on loans continue to decline; from a 37 percent annual rate at the end of 2002, bank loan rates are now down to 24 percent. Deposit rates are now in the 11 percent range, so there is now a zero real rate being paid on deposits rather than the negative real rate in the recent past, as inflation has dropped. The mega projects (Mozal and the Sasol gas pipeline) have had a major impact on the balance of payments; Mozal II has boosted exports some 60 percent and imports of raw materials (especially alumina) have also risen dramatically.

¶4. (SBU) Structural conditions and benchmarks for 2004 are reported to be generally positive with some shortfalls. The conditions regarding submission of the draft general tax law to parliament, the strengthening of the Bank of Mozambique's balance sheet by shifting IRS external debt to the Treasury, and close monitoring of the performance of the country's largest bank, Banco Internacional de Mozambique (BIM) have been met. Indeed, BIM was described as both profitable and prudential. However, benchmarks performance was described as mixed. Specifically, submission to the parliament of the law to create the Central Revenue Authority (CRA) was two weeks late, budget reporting using the computerized government accounting system "SISTAFE" is delayed, and the strategy for resolving difficulties with two small banks is only half complete. However, regulations to implement the new financial law have been drafted, the micro-finance regulations are being prepared, and the feasibility study to divest GRM holdings in BIM should be ready by year's end.

¶5. (SBU) For 2005, the Fund projects generally favorable performance. Real GDP will grow in the 7 to 7.5 percent range while price inflation will slow to 8.5 percent. Aid flows will continue rising, reaching USD 820 million, up from USD 740 million in 2004. Fiscal policy will hold steady, with the domestic primary deficit unchanged at 3.3 percent of GDP. The government's wage bill, a point of contention in the review a year ago, will appear to go up as a percentage of GDP because of a change in classification of expenditures. Moreover, government proposes to add 10,000 new employees in priority sectors, 5000 of which in education alone, so the Fund expects that nominal wages and salaries for the public service will increase less than inflation.

¶6. (SBU) Structural developments expected in 2005 include approval of the CRA law by the parliament, and the issuance of implementing regulations. Delays in the implementation of SISTAFE mean the first budget execution report generated by the new system will be for the first quarter of 2005. The Fund will provide technical assistance in monetary and exchange rate management and in bank supervision management. Reviews of the largest four banks leading to their transition to international accounting standards (IAS) will be completed by end 2004, paving the way to IAS adoption in early 2005. A draft law clarifying and improving the foreign exchange regime will be submitted to parliament in the second half of 2005. The GRM will strengthen the balance sheet of the central bank over the three year period 2005-2007 by issuing securities to the central bank.

¶7. (SBU) Private sector problems were given considerable emphasis in Mr. Di Tata's presentation. He deplored the high cost of doing business in Mozambique and welcomed the issuance of new business license regulations during the IMF's visit. He called attention to delays with customs clearances, both import and export. He is counting on the establishment of a "dry port" at Ressano Garcia, on the border with the Republic of South Africa and the principal entrepot for overland commercial traffic. He noted that the private sector believed that the decree of December (2003) liberalizing the use of ex-pat labor in Mozambique was working well, but he called for further labor sector reforms, particularly

in severance compensation and work regulations, in a new draft law to be presented to parliament by the end of 2005. Di Tata is also expecting continued progress in privatizing the state airline LAM, the telephone company TDM and its cell phone spin-off MCel, as well as water supply companies and the ports and railways conglomerate CFM.

¶8. (SBU) Public sector reform is of vital importance and implementation is seen as a long term program of the World Bank. The Fund is concerned with the linkage of wages to productivity in the public sector. The Fund is also following closely the development of a new decree regulating public sector procurement under the SISTAFE law.

¶9. (SBU) Land tenure regulations came up near the end of Mr. Di Tata's presentation. In the GRM's letter of intent to the Fund for the new PRGF, Government announced plans to issue a decree to regularize property rights in urban areas before end-July 2004. The draft decree was taken up in the Council of Ministers, and it was decided that further studies were needed and that the final decision would be put off until after the December 2004 election. Mr. Di Tata also called attention to the letter of intent's commitment to undertake a Poverty and Social Impact Analysis (PSIA) to study land tenure issues with a view to facilitating the use of land as collateral to access bank credit. Earlier Mr. Di Tata had asked bilateral donors to finance the PSIA, and several, including Ireland, the Netherlands, Germany, and USAID have expressed willingness to do so.

¶10. (SBU) Short takes: Limited progress was reported for reform of the judicial sector. Statistics for the real sector of the economy will be improved. The National Statistics Institute will undertake a labor force survey in September 2005. The GRM will prepare a new PRSP (PARPA in Portuguese) for February 2006.

¶11. (SBU) The following points were offered during the Q and A:
-- the drop in customs revenue is not very large;
-- the flow of budget funds to the provinces will catch up in the second half of the year;
-- SISTAFE has been delayed but by the end of 2005, 60 percent of the budget will be covered by the new system;
-- the Fund had no time to examine the discrepancies between the Budget Execution Report and the mid-year report to the parliament on implementation of the 2004 Economic and Social Plan;
-- as a follow up to the Safeguards Mission of the IMF, a Statistics Mission is working with the central bank to reconcile monetary statistics;
-- donor timing of budget support disbursements is better in 2004 than in 2003, and the amount is holding steady at 13.5 percent of GDP;
-- to achieve the Millennium Development Goals, the Fund is encouraging donors to provide more assistance into sound activities commensurate with GRM's absorptive capacity, and the Fund is not concerned with reducing aid dependency in the short- and medium-term as long as macroeconomic stability is not affected in a negative way;
-- GRM management of the economy in the run-up to elections has been very good in terms of stability, maintenance of the program, structural reforms, and macro management-- Di Tata said "good job";
-- there has been some appreciation of the real effective exchange rate as a result of forex reserve accumulation and the corresponding issuance of government paper (T-bills) and the Fund is encouraging greater use of forex reserves instead -- the accumulated appreciation in 2004 now is at about 6.5 percent. [According to the Standard Bank of South Africa's branch in Maputo, the appreciation has been 10.7 percent against the USD, 2.0 percent against the ZAR, and 7.2 percent against the EURO for the 12 months ending September, 2004].
-- The appreciation of the metical does not bode well for Mozambique's traditional exporters.
-- VAT refund delays are a problem and arise to some extent from the undertakings to waive VAT for flood reconstruction projects but the Fund is not getting too involved. Di Tata remarked that some refund claims were not justified. In give and take on this point it was opined that the system of refunds is too complicated and that the VAT authorities can always find a fault with any refund application. Concern was expressed that the GRM "budget" for refunds was too low compared with legitimate refund obligations. The IBRD's Peter Moll, attached to the IMF Mission, believes that the GRM can meet the 60 day refund target and perhaps lower it. The tripartite VAT

Refund Task Force, agreed to in the GRM/G-15 Joint Review in March-April 2004, is still to be convoked.
-- the Fund does not consider Mozambique's external or internal debt position to be a problem at present;
-- the Fund agrees that there is some validity to the need to simplify and perhaps reduce income tax rates, and a Fund Fiscal Affairs Department Mission was examining this question while the PRGF Mission was in Maputo. However, there is no consideration being given to reducing the VAT rate of 17 percent;
-- trade issues are being led by the World Bank, the top tariff rate will come down to 20 percent (from 25 percent) in 2006, and there will be no major changes in trade policy in 2005;
-- the Swiss Ambassador and chair of the G-15 budget support donors (USAID is an observer) looked for increased harmonization of the IMF with the G-15, commented that the G-15 concerns were not with macro performance but with [1] the private sector, [2] the judicial sector, and [3] the banking system and bank supervision. Mr. Di Tata agreed with [1] and [2], did not fully agree with [3], and added [4] HIV/AIDS;
-- the head of French Cooperation challenged the IMF to 'harmonize' more closely with the work of the G-15 budget support donors. Di Tata threw up his hands and asked what the Fund should do differently. The G-15 wants earlier and better budget projections and better leadership from the Ministry of Plan and Finance (MPF). The Mid Year Review and the IMF Mission were plagued by last minute and inadequate presentations by the GRM. The IBRD member of the Mission said the MPF doesn't have the sector expertise necessary for the job.

¶12. (SBU) Comment: The IMF team was clearly pleased with performance to date but noted some reluctance on the part of the authorities to commit for the new administration that is expected to take office in January 2005. The Fund noted that it was the GRM's purpose in seeking the new PRGF to commit the new administration to follow on with the reform process. We are pleased with the IMF's concern about the needs of the private sector and will work closely with the Resident Representative to pursue the achievement of the liberalization agenda that we share. End comment.
DUDLEY